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California's GO Rating Raised To 'A', Off Watch, After Elimination of Near-Term Liquidity Pressure

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Rationale

Standard & Poor's Ratings Services raised its rating on California's $32.8 billion of outstanding GO bonds to 'A' from 'BBB' and removed the rating from CreditWatch, where it had been placed March 3, 2004.

At the same time, Standard & Poor's raised its rating on the state's $7.3 billion of outstanding lease debt to 'A-' from 'BBB-', as well as its rating on $2.6 billion of Golden State Tobacco Securitization Corp. bonds, series 2003B, with general fund support.

The upgrades reflect the easing of immediate liquidity pressure on the state following the sale of $11.3 billion of long-term bonds to fund past and current general fund operating deficits from a $15 billion bond authorization passed March 2, 2003. The deficit bonds aided in the retirement of $12.5 billion of notes that matured in June 2004.

The upgrades are also based on the state's recent economic improvement, along with an enacted fiscal 2005 state budget that is still reliant on substantial amounts of long-term borrowing to achieve balance. The budget will likely enable the state to avoid substantial further short-term borrowing to fund deficits through at least fiscal 2006.

Also factored into the rating, however, is the continued structural deficit between ongoing revenues and expenditures, coupled with future fiscal pressure due to promises made to substantially increase funding for local governments, schools, and state higher education institutions in fiscal 2007.

The state will still most likely show a large unreserved general fund balance deficit on an audited GAAP basis at the end of fiscal 2004, despite the sale of the deficit funding bonds, in light of the $6 billion difference between budgetary basis and GAAP general fund balances at fiscal year-end 2003. California has a history of late budgets and overly optimistic budget assumptions, caused, in part, by constitutional structural impediments.

The state's two-thirds legislative budget approval requirement allows both foes of spending cuts and groups opposing tax increases to have effective veto power over the budget, despite revenue softness since fiscal 2002. The result has been a compromise in recent years in terms of both high levels of spending and no tax increases, achieved through the use of unrealistic revenue assumptions--and borrowing when assumptions proved unattainable. It is not yet clear whether this cycle has been broken. The fiscal 2005 state budget is balanced with the use of $2 billion of deficit bonds and $929 million of additional general fund-supported debt to make pension payments totaling about 3.7% of budgeted appropriations. The state's net tax-supported debt level has nearly doubled over the past four years to a still moderate $1,444 per capita. The utilization of debt to balance budgets has somewhat diminished the state's financial flexibility compared with prior periods.

The budget contains several difficult-to-estimate revenue assumptions relating to additional federal revenues, yet-to-be-approved tribal gaming compacts, punitive court damage awards, and assumptions about state employees choosing to take early payout of pension contributions, as well as the assumption of strong personal income growth of more than 5.6%. The final state budget increased general fund appropriations about $1.1 billion over Gov. Arnold Schwarzenegger's May proposal, while increasing revenues about $600 million, mostly by raising revenue growth assumptions.

The fiscal 2005 budget appears to narrow the structural deficit from fiscal 2003's actual $6 billion operating deficit, and cuts spending in comparison with what would occur absent legislative changes. However, the budget still increases overall general fund spending compared with previous years and may increase the operating deficit, absent bonding, compared with fiscal 2004.

The state ended fiscal 2003 with a huge GAAP negative general fund balance of $13.4 billion, equal to 17.5% of expenditures, and a negative unreserved balance of $15.4 billion. On the more favorable budgetary basis of accounting, the state calculates it ended fiscal 2003 with a general fund reserve deficit of $8.6 billion, which was wholly funded by $11.3 billion of deficit bonds and roughly $2 billion of tax amnesty windfall receipts. The state estimates it incurred another $1 billion budgetary basis general fund operating deficit in fiscal 2004, absent bonding, and is balancing its fiscal 2005 budget with $2 billion of deficit bonds to fund fiscal 2005 appropriations out of its total March deficit bond authorization of $15 billion, plus $929 million of general fund-supported pension bonds. The state legislative analyst's office has estimated that current programs and promises to increase local government, transportation, school, union contract, and university spending might, absent legislative changes, produce an increased structural deficit of as much as $7 billion-$8 billion per year beginning in fiscal 2007.

Outlook

The current rating outlook is stable based on the elimination of near-term liquidity pressures following the sale of long-term deficit funding bonds, balanced against the use of approximately $3 billion of long-term bonds to balance the fiscal 2005 budget and substantial projected increases in expenditures in fiscal 2007 that will make balancing out-year budgets difficult.

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